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No. 95-436

In the Supreme Court of the United States

OCTOBER TERM, 1995

MACH-TECH, LTD. PARTNERSHIP, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether the research and development expenditures involved in this case were made "in connection with [a] trade or business" of the taxpayer within the meaning of Section 174 of the Internal Revenue Code.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-6a) is unofficially reported at 95-2 U.S. Tax Cas. (CCH) ¶ 50,375. The opinion of the Tax Court (Pet. App. 8a-29a) is unofficially reported at 67 T.C.M. (CCH) 2984.

JURISDICTION

The judgment of the court of appeals was entered on June 16, 1995. The petition for a writ of certiorari was filed on September 14, 1995. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner Serv-Tech, Inc. was engaged in industrial and chemical cleaning (Pet. App. 9a). Petitioner Mach-Tech, Ltd. Partnership (the partnership) was formed in 1983 to engage in the research, development, and operation or licensing of a fully enclosed mobile heat exchange bundle cleaning system (the Fast Clean System) to be used in hydroblast cleaning of equipment used in the oil and gas industry (*ibid.*). Serv-Tech was its general partner (*ibid.*).

Richard Krajicek, the co-inventor of the Fast Clean System, was Serv-Tech's president and chairman of its board of directors. Between December 1, 1983 and June 30, 1986, Krajicek owned from 34 to 40.5 percent of Serv-Tech's stock (Pet. App. 10a). Krajicek also held a 29.7 percent ownership interest in the partnership. Edward Randall, III, an investment banker who had known Krajicek for more than 20 years, held a 39.6 percent stake in the partnership (*ibid.*).

On December 29, 1983, shortly after the limited partnership interests were sold in a private offering, the partnership executed a research and development agreement with Mach-Tech, Inc., a subsidiary of Serv-Tech (Pet. App. 10a). This agreement required Mach-Tech, Inc. to use its best efforts to develop the Fast Clean System in return for a fixed fee in the amount of $347,500, which the partnership was to pay in two installments (*id.* at 10a-11a). The first installment of $250,000 was paid to Mach-Tech, Inc. on December 31, 1983, and the second installment of $97,500 was due during 1984 (*id.* at 11a).

On December 29, 1983, the partnership also gave Serv-Tech the option to acquire a nonexclusive license to manufacture and use the Fast Clean Sys-

tem for 18 months after the technology was reduced to commercial practice, followed by a further option, exercisable upon expiration of the first license, to acquire an exclusive license to exploit the Fast Clean System (Pet. App. 11a-12a). Under this agreement, the partnership could not "sell, alienate, assign or otherwise transfer any right, title, interest or license" to the Fast Clean System without offering Serv-Tech the option afforded by the two license provisions (*id.* at 11a). Serv-Tech was to pay the partnership a 12.5 percent royalty based on gross revenues in 1984 and 1985, and a 2 percent royalty thereafter (*id.* at 12a). Finally, the partnership granted Serv-Tech an option, exercisable from 1985 through 1987, to issue stock in Serv-Tech in exchange for the limited partners' interests, provided that Serv-Tech stock was then publicly traded (*id.* at 12a-13a).

The partnership's private offering memorandum stated that Serv-Tech would "acquire * * * [the Fast Clean System], once developed, instead of the Partnership retaining it for use in its own trade or business" (Pet. App. 13a). The private offering memorandum set forth projections of the anticipated income of the partnership. These income projections were based on the assumption that the partnership would be receiving royalties from Serv-Tech and would not be exploiting the Fast Clean System in a business of its own (*ibid.*).

During the periods in issue, the partnership had no employees or office of its own (Pet. App. 17a). The partnership had no activities other than those already described (*ibid.*).

2. During 1985 and 1986, Serv-Tech sold and operated units of the Fast Clean System, realizing gross

revenues of approximately $1,100,000 (Pet. App. 14a). No part of the sales proceeds was paid to the partnership. The partnership also was not paid any royalties on the revenues generated during this period (*ibid.*).

The Fast Clean System was regarded as ready for general commercial exploitation on January 1, 1986 (Pet. App. 14a). On January 2, 1986, Serv-Tech executed a nonexclusive license agreement with the partnership for an 18-month term (*ibid.*). In February, 1986, the inventors of the Fast Clean System (Krajicek and Robert R. Cradeur) assigned all of their rights in the System to the partnership (*id.* at 14a-15a).

Because its stock was not publicly traded, Serv-Tech was unable to exercise its option to acquire the interests of the limited partners (Pet. App. 15a n.9). In May, 1986, however, Serv-Tech made an offer to exchange shares of its common stock for the interests of the limited partners if all of the limited partners agreed to the exchange (*id.* at 15a-16a). The memorandum accompanying the offer stated that the partnership's objective of developing the Fast Clean System had been met (*ibid.*) and that "[i]t is unlikely that [the partnership] could economically provide for its own account, the experienced personnel, facilities and other resources which will be necessary to market and continue development of the Fast Clean System" (*id.* at 16a). The offering memorandum stated that, if the exchange took place, Serv-Tech's current shareholders would continue to own 92.3 percent of its stock and would remain in control of its policies and business affairs (*ibid.*) In June 1986, all of the limited partners exchanged their interests in the partnership for Serv-Tech common stock (*id.* at

17a). Serv-Tech thereafter utilized the Fast Clean System in its business (*ibid.*).

3. For the taxable year 1983, the partnership claimed a current deduction for research and development expenses under Section 174 of the Internal Revenue Code in the amount of $250,000 and reported a tax preference item for such expenses in the amount of $247,917 (Pet. App. 17a-18a). For 1985, the partnership claimed a deduction under Section 174 in the amount of $118,713 and a tax preference item in the amount of $106,842 (*id.* at 18a).

The Commissioner of Internal Revenue determined that the claimed deductions were not allowable under Section 174. The Commissioner concluded that the partnership had no realistic prospect of engaging in a trade or business relating to the Fast Clean System because the grant of the exclusive license option limited the role of the partnership to that of a passive investor (Pet. App. 19a). Serv-Tech, in its capacity as the tax matters partner for the partnership, filed a petition in the Tax Court seeking redetermination of the resulting deficiencies (*id.* at 9a).

4. The Tax Court upheld the Commissioner's determinations (Pet. App. 8a-29a). The court noted that the grant of an option for an exclusive license for the Fast Clean System to Serv-Tech precluded the partnership from exploiting the technology for its own account unless Serv-Tech refused to acquire it (*id.* at 21a-22a). The court also noted that the partnership's 1983 private placement memorandum (which stated that Serv-Tech would acquire the Fast Clean System once developed) and Serv-Tech's 1986 private offering memorandum (which stated that the partnership would not be able to apply the Fast Clean System on its own) reflected that the partnership

lacked the wherewithal itself to exploit the technology (*id.* at 22a-23a). The court concluded that the partnership was no more than "a passive investor used as a financing vehicle, without an established realistic prospect of engaging in a trade or business relating to the Fast Clean System" (*id.* at 24a).

The court further concluded that any activities of Serv-Tech in applying the technology after it acquired it in the 1986 stock exchange were not relevant in determining whether the *partnership* had a realistic prospect of engaging in a trade or business. The court noted that the requisite link between the research expenditures and the taxpayer's trade and business—the link that Section 174 requires—could not be established by the fact that the trade or business of some *other* taxpayer might successfully be able to apply the technology (*id.* at 25a).

5. The court of appeals affirmed (Pet. App. 1a-6a). The court concluded that the evidence supported the Tax Court's findings that the partnership was neither engaged in a trade or business nor had a realistic prospect of ever doing so (*id.* at 4a). The court rejected petitioner's contention that the Tax Court had misinterpreted this Court's decision in *Snow* v. *Commissioner*, 416 U.S. 500 (1974), by refusing to "attribut[e]" the business engaged in by Serv-Tech to the partnership (Pet. App. 6a). The court explained that "the Tax Court did not err in finding that [the partnership], with its 7.5% interest in Serv-Tech after the merger, could not exercise the control over the exploitation of the technology as required by *Snow*" (Pet App. 6a).

ARGUMENT

The decision of the court of appeals in this fact-bound case is correct and does not conflict with any decision of this Court or of any other court of appeals. Further review is therefore not warranted.

1. Section 174 allows a taxpayer a current deduction for "research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business." 26 U.S.C. 174(a)(1). A taxpayer need not currently be conducting a trade or business to obtain a deduction for research and development expenses. The taxpayer must, however, be engaged in a trade or business to employ the technology at some time; a passive investor who finances the development of an invention for use in another's business is not entitled to the current deduction for research expenditures. *Diamond* v. *Commissioner*, 930 F.2d 372, 375 n.6 (4th Cir. 1991). The passive investor is instead to treat the research expenditures as "capital" charges (26 U.S.C. 174(a)(1)), to be recovered, if at all, upon the sale or exchange of the technology. The courts of appeals have consistently concluded that, absent a realistic prospect that the invention, if successful, will be put to use in the taxpayer's own business, the expenditure does not qualify as being made "in connection with" a business of the taxpayer. *Harris* v. *Commissioner*, 16 F.3d 75, 81 (5th Cir. 1994); *Kantor* v. *Commissioner*, 998 F.2d 1514, 1518 (9th Cir. 1993); *Diamond* v. *Commissioner*, 930 F.2d at 375; *Spellman* v. *Commissioner*, 845 F.2d 148, 149 (7th Cir. 1988).

In this case, the Tax Court and the court of appeals correctly concluded that the evidence indicates that

the partnership lacked a reasonable prospect of exploiting the technology in a trade or business of its own. The partnership had no employees of its own and had no office other than that of its general partner, Serv-Tech (Pet. App. 17a). As the partnership's 1983 private offering memorandum attests, the partnership never intended to engage in a trade or business of its own. Instead, it was contemplated that the partnership would finance the development of the Fast Clean System and that Serv-Tech would assume the risks and rewards of taking the product to market in return for royalties to the partnership (Pet. App. 13a). On December 29, 1983, shortly after limited partnership interests were offered by means of a private offering memorandum, the partnership granted Serv-Tech an option to acquire an exclusive license to exploit any product resulting from the undertaking, in return for a passive royalty interest in the gross revenues (*id.* at 11a). The partnership made its agreement to develop the product with Mach-Tech, Inc., on that same day, and the partnership made its first $250,000 payment to that company only two days later (*ibid.*). The contemporaneous timing of the partnership's formation, its grant to Serv-Tech of options to acquire any technology developed, the partnership's execution of the development agreement with Mach-Tech, Inc., and its payment to Mach-Tech, Inc. of the first installment due under that agreement reflect that the partnership was formed as a financing device. Moreover, it is evident that the partnership was not positioned to exploit any untapped profit potential even if Serv-Tech had waived its option. The partnership had expended its capital in payments to Mach-Tech, Inc., and lacked both the staff and the

financial resources to market any resulting product (*id.* at 16a).

This substantial evidentiary record plainly supports the finding, concurred in by both courts below, that the research and development expenses were not incurred "in connection with" any current or prospective business of the partnership, as Section 174 requires. Further review of this factual issue is not warranted. See *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1985).

2. There is no merit to petitioners' contention (Pet. 10-13) that the decision of the court of appeals conflicts with the decision of this Court in *Snow* v. *Commissioner*, 416 U.S. 500 (1974). Petitioner contends that the ability of the taxpayer to control the development and implement future exploitation of the technology was not required in *Snow*. That case, however, involved markedly different facts. The taxpayer in *Snow* was a partnership that had changed to a corporate form by the time it reached the exploitation stage. *Id.* at 502 n.3. Because the corporation (which, in *Snow*, exploited the technology) was the successor of the partnership, the change in the form of ownership was not relevant to the issues presented in that case. Instead, *Snow* addressed only the question whether an infant business that is in the research and experimental stage of product development may currently deduct its expenses *before* it thereafter commences commercial use of the technology. See *id.* at 502 & n.3. The conclusion in *Snow* that a taxpayer who later uses the technology in its own "trade or business" may obtain the deduction under Section 174 obviously does not conflict with the conclusion in this case that such a taxpayer may *not* obtain the current deduction if there was no realistic

prospect that the taxpayer would thereafter exploit the technology in its own "trade or business."

The requirement that there be a realistic prospect that the taxpayer—rather than some *other* entity—will exploit the invention is imposed by Section 174 itself, for the statute requires the taxpayer to incur the research expenses in connection with "his" trade or business. 26 U.S.C. 174(a)(1). Nothing in *Snow* addressed, much less eliminated, this express statutory requirement. There is thus no conflict between the decision in this case and the decision in *Snow*.

Because the decision in this case does not conflict with *Snow*, there is no merit to petitioners' further contention (Pet. 20-24) that this Court should address the degree of control that a taxpayer must exercise over the ultimate exploitation of new technology in order to be entitled to the deduction permitted by Section 174. Petitioners, moreover, misconstrue the decision below (Pet. 20) in stating that it requires a taxpayer to own a majority interest in the company that eventually markets the technology in order to deduct research and development expenses. The court of appeals did no more than find that there was no clear error in the Tax Court's conclusion that the partnership, "with its 7.5% interest in Serv-Tech after the merger," could not exercise the required future control over exploitation of the technology (Pet. App. 6a).

As the court of appeals correctly concluded (Pet. App. 6a), the question of control is ultimately one of fact. The Tax Court found that the partnership did not establish a sufficient "operational nexus," either before or after the merger with Serv-Tech, between its expenditures and a current or prospective trade or business of its own (*id.* at 25a). That finding is amply

supported by the evidence and does not warrant further review.

3. Petitioners also err in contending (Pet. 13-19) that the decision in this case conflicts with *Smith* v. *Commissioner*, 937 F.2d 1089 (6th Cir. 1991), and *Scoggins* v. *Commissioner*, 46 F.3d 950 (9th Cir. 1995). Those cases are readily distinguishable.

In *Smith*, the partnerships did not (as in this case) grant another firm an exclusive license to produce and sell any viable technology that might emerge from the undertaking. 937 F.2d at 1091. Similarly, in *Scoggins*, the research and development company that contracted with the partnership could exercise its option to acquire the technology only by first paying $5 million. 46 F.3d at 951. That substantial price made it uncertain whether the corporation would acquire the technology at all and, consequently, left the partnership with a reasonable prospect of exploiting the technology in a trade or business of its own. In this case, by contrast, Serv-Tech was not required to make a substantial down payment to acquire rights to the Fast Clean System. Instead, Serv-Tech was required only to pay the partnership a percentage of the gross revenues from its exploitation of the invention, and the royalty rate fell after the first two years to the minimal rate of two percent (Pet. App. 12a). Moreover, Serv-Tech never paid the royalties that it owed under its license, even though it realized substantial gross revenues from the invention (*id.* at 14a). The options granted by the partnership in this case manifestly consigned it to the role of a passive investor with no realistic prospect of engaging in a trade or business on its own account.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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